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TAX EFFECT OF FORM IN THE ACQUISITION OF ASSETS

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THE development of federal income tax jurisprudence is really a history of the ceaseless struggle between tax planners and those charged with the protection of the revenue. Early recognition was given to the principle that the taxpayer had the right to arrange his affairs in such a way that his tax burden was minimized.[1] This opportunity stimulated the ingenuity of tax counselors. Resourceful tax strategists tailored transactions so that they sidestepped troublesome regulations, decisions, and statutory provisions, and came within favorable ones.[2] To meet the challenge of artificial arrangements concocted solely for tax purposes, the courts introduced the doctrine that it is the substance of transactions and not their form which is controlling.[3]

Confronted with the crystallization of the substance-over-form concept, taxpayers became much more careful in adopting disguises with which they hoped to obtain favorable tax results.[4] No longer could one readily distinguish be-

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1. *See* United States v. Isham, 17 Wall. 496, 506 (U.S. 1873).

2. It became apparent early that the language of the tax statutes, even as broadened by interpretative regulations, could not forestall ever increasing planning for tax minimization. *Compare* Bowring v. Bowers, 24 F.2d 918 (2d Cir. 1928), *with* National Lead Co. v. United States, 252 U.S. 140 (1920).

3. Gregory v. Helvering, 293 U.S. 465 (1935); Weiss v. Stearn, 265 U.S. 242 (1924). Under this doctrine obvious attempts to disguise the real nature of events have been struck down. See, *e.g.*, Higgins v. Smith, 308 U.S. 473 (1940); Griffiths v. Commissioner, 308 U.S. 355 (1939). The courts began to tie together a series of related events and to affix taxes on the basis of the total changes from beginning to end. See, *e.g.*, Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938); Commissioner v. Ashland Oil & Refining Co., 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939); Electrical Securities Corp. v. Commissioner, 92 F.2d 593 (2d Cir. 1937). And there has crept into the sections of the Code dealing with tax-free entity changes a requirement that they be activated by a "business purpose." Gregory v. Helvering, 293 U.S. 465 (1935).

On the whole the Treasury Department wisely selected the cases in which to urge new theories to counter tax avoidance. Thus the substance-over-form principle was shaped in extreme fact situations, where there was no difficulty in spotting the taxpayer's real aims.

4. With the steep increase in tax rates in recent years, tax consciousness has attained new heights, and the search for ways to realize favorable tax results has taken on the character of a crusade. See, *e.g.*, Commissioner v. Korell, 339 U.S. 619 (1950); Chamberlin

tween what was really intended and what was done; the black-and-white situation took on grey overtones. For example: *A* is a stockholder-employee of *B* corporation, and his conduct in and out of the company's business activities is jeopardizing its continued success. *A* is willing to sever all of his connections with *B* corporation if he is paid fair market value plus $50,000 for his stock. Both parties realize that the additional amount is being paid solely to get rid of *A*. However, *A* seeks capital gain treatment on the entire amount, and therefore insists that the contract of purchase recite the sum total of the two amounts as consideration for the acquired stock. This is done, and the transaction is effected. *A* reports the entire gain realized as long-term capital gain. *B* corporation deducts $50,000 as an ordinary and necessary business expense. How are these inconsistent positions to be treated?

This article deals with the tax consequences to the parties when assets are purchased, and either the total price or the amount allocated to each asset in the contract does not accurately reflect the substance of the transaction. Analysis of this aspect of asset acquisition will seek the substance of transactions in which the underlying objective is one of the following: (1) to end burdensome relations with the seller; (2) to confer a benefit on the seller or the buyer; (3) to obtain an asset different from that which is sold.

Acquisitions to Avoid Burdensome Relations

The right to deduct a cash payment made in the course of business to eliminate harmful relations hinges only on proof that the expenditure is ordinary and necessary.[5] This requirement is met if the outlay is proximately related to the business, is beneficial, and would have been incurred by others in like circumstances.[6] In applying these criteria, certainty is not the test; a reasonable belief that the expense is necessary to promote or protect the business is sufficient.[7] Under this doctrine of reasonableness, taxpayers have deducted sums paid to terminate unfavorable contractual obligations,[8] compromise threatening litigation,[9] and sever prejudicial business relationships.[10]

Assurance of favorable tax treatment, however, disappears when the protective payment takes the form of, or is linked with, an asset acquisition. The purchaser must contend with the deeply rooted, and oft-repeated principle that capital expenditures are not deductible.[11] When bargaining conditions

v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954). Tax factors are of prominent and often controlling significance in the determination of how a business or real estate deal is to be made.

5. Int. Rev. Code § 23(a) (1) (A).

6. Kornhauser v. United States, 276 U.S. 145 (1928).

7. Levitt & Sons, Inc. v. Nunan, 142 F.2d 795 (2d Cir. 1944).

8. Cassatt v. Commissioner, 137 F.2d 745 (3d Cir. 1943); Denholm v. McKay Co., 2 B.T.A. 444 (1925), *acq.* IV-2 Cum. Bull. 2 (1925).

9. International Shoe Co., 38 B.T.A. 81 (1938), *acq.*, 1938-2 Cum. Bull. 17; H. M. Howard, 22 B.T.A. 375 (1931), *acq.*, 1945 Cum. Bull. 4.

10. A. King Aitkin, 12 B.T.A. 692 (1928), *non-acq.*, VIII-1 Cum. Bull. 50 (1929).

11. See, *e.g.*, Welch v. Helvering, 290 U.S. 111 (1933).

require him to consent to having the transaction shaped as a purchase, substantial tax benefit will depend on his subsequently contradicting his own agreement.

Where the facts disclose that the only purpose of the arrangements was contract termination or settlement of a dispute, the capital purchase aspect has been cast aside. In two cases,[12] the courts permitted the purchaser to deduct as a business expense the entire price paid for stock in a corporation, because the stock was obviously acquired only to discharge an agency contract. In each instance, the plan provided for stripping the corporation of all assets other than the contract prior to the sale of stock. The same result was reached where a suit for breach of an exclusive contract to sell a patented article was ostensibly settled by a lump-sum payment for the agent's transfer of his non-existent interest in the patent.[13] In these cases the courts were confronted with an all-or-nothing choice between whether an asset was purchased or a burdensome relationship was ended. Since the courts held that there was really no asset sold, they encountered no difficulty in permitting the deduction.

It is quite different when the parties are actually bargaining both for the transfer of an asset and for the consummation of an ordinary income transaction, but the agreement takes the form of an augmented price for the asset. Here, the purchaser has a twofold task. First, he must convince a court to go behind the contract and root out the essence of the transaction.[14] Then he must sustain the difficult burden of overcoming the provisions of a written contract by proving that part of the purchase price represents a bargained-for consideration for the termination of an undesirable relationship.

This was accomplished by a fortunate taxpayer in *Cleveland Allerton Hotel, Inc. v. Commissioner*.[15] In order to be free of an onerous rent obligation, a lessee paid a single sum of approximately $440,000 to acquire the leased premises, which was proved by uncontradicted evidence to have a value of not more than $200,000. In upholding the right to deduct the excess, the Sixth Circuit noted:

> "If numerous admonitions that taxation is a practical matter, that taxing authority may look through form to substance, is not mere rhetoric where the taxpayer's interest is involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that the petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business."[16]

12. Helvering v. Community Bond & Mortgage Corp., 74 F.2d 727 (2d Cir. 1935); Pressed Steel Car Co., 20 T.C. No. 24 (1953).

13. Camloc Fastener Co., 10 T.C. 1024 (1948), *acq.*, 1948-2 Cum. Bull. 1.

14. Parol evidence is admissible to vary or contradict the agreement. Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939); Landa v. Commissioner, 206 F.2d 431 (D.C. Cir. 1953).

15. 166 F.2d 805 (6th Cir. 1948).

16. Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805, 807 (6th Cir. 1948). This decision has some perplexing aspects. The court treats the problem as "clearly a case of first impression." *Id.* at 805. Completely overlooked was Olympia Harbor

Cleveland Allerton was almost completely ignored by the judiciary until very recently. One would expect that both taxpayers and the Commissioner could rely on this first clear exposition of the principle of substance over form in a transaction which lumps together an asset acquisition and a deductible expense. Less than six months after *Cleveland Allerton* was decided, a district court failed to cite it in a case involving an over-all payment made to acquire assets and to end a potentially destructive suit.[17] Peculiarly, however, this court almost paraphrased the language in *Cleveland Allerton* to the effect that the determination of the amount of the protective payment was simply a matter of subtracting the fair market value of the property from the total price.[18]

Perhaps because of this oversight, the Tax Court has now seen fit to disagree with the opinion in *Cleveland Allerton,* and has reasserted the very conclusion which was reversed by the Sixth Circuit in that case. In *Millinery Center Building Corp.,*[19] the petitioner who had erected and fully depreciated a building upon leased land, purchased the land from the lessor at a price which was shown without contradiction to exceed its value by the amount of $1,400,000. Granting the existence of a burdensome lease, a majority of the Tax Court nonetheless held that no part of this excessive payment was deductible.[20] With respect to this holding, one might well quote the comment made in *Cleveland Allerton* that such disallowance "requires, it seems to us, a naiveté not attributable to experienced and sophisticated taxing authority."[21]

In *Millinery Center,* the Tax Court did not draw upon other precedents in the field of taxation dealing with the search for reality over appearances. While this was a failure to recognize a common principle of tax jurisprudence, it cannot be said that the application of the principle is simple. A court must be asked to ignore or override the written record of an event and to substitute a finding of real intention based on testimony offered by a party who stands to reap substantial benefit. A desire to protect the revenue, a feeling that a man should not be permitted to contradict his own act, and other factors personal to a judge, coupled with the still amorphous character of the doctrine, have naturally made for inconsistency and lack of clarity of expression.

Lumber Co., 30 B.T.A. 114 (1934), *aff'd,* Olympia Harbor Lumber Co. v. Commissioner, 79 F.2d 394 (9th Cir. 1935), allowing a deduction of the excess of purchase price over fair market value of materials acquired by the taxpayer to terminate an equipment installation contract. Other unnoticed cases in point were Helvering v. Community Bond & Mortgage Corp., 74 F.2d 727 (2d Cir. 1935), and A. King Aitkin, 12 B.T.A. 692 (1928).

17. Lomas & Nettleton Co. v. United States, 79 F. Supp. 886 (D. Conn. 1948).

18. *Compare id.* at 895, *with* Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805, 807 (6th Cir. 1948).

19. 21 T.C. No. 92 (1954).

20. The court further held that the excess was not amortizable over the term of the lease nor depreciable over the remaining life of the building. Millinery Center Building Corp., 21 T.C. No. 92, at 6. Six judges dissented on the ground that some part of the purchase price should have been added to the cost of the building. *Ibid. Cf.* Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953).

21. Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805, 807 (6th Cir. 1948).

The difficulty in handling the problem is well illustrated by the considerable number of cases dealing with payments allegedly made to induce the withdrawal of a member from a partnership. In general, these decisions involve similar facts. One partner is guilty of conduct, or is threatening action, which is prejudicial to the best interests of the firm. The other partners buy him out to protect the partnership business. It is obvious that a recalcitrant retiring partner can drive a hard bargain in such a situation. The remaining partners must get rid of him or accept the alternatives either of doing nothing and having the enterprise ruined, or commencing lengthy and expensive dissolution proceedings. The offending partner is in a position to demand, and probably receive, a payment exceeding the value of his interest in the partnership.

The Buyer: Business Expense or Capital Expenditure?

When the parties have allocated the contract price, the purchaser has usually been able to deduct the excess payment as a business expense. In an early partnership case,[22] the two remaining partners purchased in dissolution of an advertising agency all of the improperly behaving partner's interest in firm assets except his advertising accounts. They paid a price equal to his capital account and share of undivided profits plus $5,000. Finding that the $5,000 was expended to obtain the withdrawing partner's consent to an immediate dissolution, the Board of Tax Appeals allowed the continuing partners a business deduction in that amount. In a later case,[23] a partner was allowed to deduct a cash sum paid to his son-in-law partner whose activities were damaging the business of the firm. Here, the taxpayer did not acquire an asset, since the partnership interest of the son-in-law was purchased by two other partners.

In subsequent cases denying deductions, the parties had failed to allocate the contract price. The first of these decisions was predicated on the Board's interpretation of the facts.[24] It determined that the payment was made to acquire the retiring partner's share of the partnership's substantial goodwill, and that the asserted purpose to avoid litigation was merely incidental. One might challenge the merits of this finding of fact.[25] But once the fact is found, there can be no quarrel with the legal conclusion which stemmed from it.

Much more troublesome is the opinion in *Burt L. Davis*.[26] The remaining partners purchased from the retiring partner, who was demanding control and threatening to institute receivership proceedings, all of his interest in the in-

22. A. King Aitkin, 12 B.T.A. 692 (1928), *non-acq.*, VIII-1 CUM. BULL. 50 (1929).

23. Charles F. Mosser, 27 B.T.A. 513 (1933), *non-acq.*, XII-1 CUM. BULL. 20 (1933).

24. Arthur P. Williams, 24 B.T.A. 1070 (1931).

25. No account for goodwill was ever carried on the partnership books. *Id.* at 1073. The agreement did not specifically provide for any payment for goodwill. *Id.* at 1077. The remaining partners felt that the retiring partner's claim for payment of a goodwill account lacked merit. *Id.* at 1073. But they believed that the retiring partner would sue on this claim and that such suit would be harmful to the firm; and they paid an additional sum to the retiring partner to settle his claim. *Id.* at 1074.

26. 26 B.T.A. 218 (1932).

surance brokerage business of the partnership, including his interest in the partnership name, furniture, fixtures, contracts, records, and all other assets. The retiring partner reserved the right to compete, including the privilege of soliciting partnership customers. The purchasing partners vacillated in their tax treatment of the $90,000 which was paid. On their individual returns they deducted a pro rata part of the entire payment under an amortization approach.[27] Before the Board, they sought to deduct the $90,000 in the years in which installment payments were made, either as losses or as ordinary and necessary business expenses.

The Board found that both tangible and intangible assets were acquired in consideration of the sum expended.[28] This would justify a holding that not all of the $90,000 was deductible. But the decision went much further. It excluded testimony offered by the petitioners to show that the purchase was made under duress, and that the $90,000 was paid only to forestall the threatened receivership which would wreck the business.[29] The Board's rationale was that no deduction is permissible, notwithstanding motive of payment, or disparity between price and value, if capital assets of some value were acquired in the transaction.[30]

Adherence to this all-or-nothing concept continues. Petitioners in one recent case sought to deduct only the amount exceeding the value of the departing partner's capital account.[31] Overlooking this distinction from the *Davis* case, the courts ignored the motive occasioning the excessive payment,[32] and proof that no goodwill was involved in the acquisition.[33] The deduction was disallowed because of the accompanying purchase of the partnership interest. An even more extreme illustration of the swing of the pendulum is the *Ethel Sperling* decision.[34] Here, the agreement between the parties segregated the deductible item, and expressly provided that it was paid to induce the retirement of the recipient partner. This did not shake the Tax Court's conviction that the transaction was no more than the sale of a partnership interest to the remaining partners.

Although these recent decisions can be explained by the all-or-nothing concept because an asset was acquired, their language suggests that the denial of a deduction was predicated on a different ground. The opinions indicate that the additional amount was really expended to obtain another valuable asset—

27. No explanation was advanced by the court or the taxpayers regarding the theory underlying this treatment of the payment. The taxpayers abandoned the amortization approach at the trial.

28. Burt L. Davis, 26 B.T.A. 218, 223 (1932).

29. *Id.* at 222-3.

30. *Id.* at 223.

31. N. Paul Kenworthy, 11 CCH TC MEM. DEC. 60, *aff'd per curiam*, Kenworthy v. Commissioner, 197 F.2d 525 (3d Cir. 1952).

32. The taxpayers sought the withdrawal of a partner because his conduct threatened the business of their firm. N. Paul Kenworthy, 11 CCH TC MEM. DEC. 60, 62, 63 (1952).

33. *Id.* at 66.

34. Ethel Sperling, 20 T.C. No. 141 (1953).

the right to continue the business under the firm name without interruption.[35] In essence this is a masked finding that the payment was made to procure an intangible asset akin to goodwill. It is not expounded bluntly, perhaps because the taxpayers offered considerable testimony to show that there was no goodwill attached to the entity.[36] If the court, notwithstanding such evidence, believed that the circumstances of the settlement pointed to a goodwill acquisition, a frank statement to that effect would have eliminated both the need to cling to formalism and the creation of precedent which may prove embarrassing when goodwill is clearly not present.

The Seller: Ordinary Income or Capital Gain?

Theoretically, the tax treatment of the seller should be consistent with that of the purchaser. If the seller receives payment as consideration for the termination of a legal relationship, unattended by the sale or exchange of any property, the payment should be ordinary income. And when part or all of the amount paid under an arrangement which looks like the sale of an asset is allowed as a deduction to the purchaser, the same amount should be ordinary income to the seller. The ground for the deduction is the determination that some part of the purchase price is a disguised tribute for the seller's agreement to release the payor from a burden. As such, it is not entitled to capital gain treatment on the seller's tax return.[37] Conversely, when a sale in form withstands a challenge that it is something different in substance, the seller should realize his desired capital gain.

There is a considerable possibility, however, of a variance between theory and practice in these instances. The seller's return may not be examined within the period for the assessment of a deficiency; both seller and buyer may be denied tax benefit because neither can overcome the burden of proof;[38] or both can be successful in their assertions because in separate proceedings each presents the favorable elements, and the Government either is unable to muster the contrary evidence or proceeds on an erroneous analysis of the transaction.[39]

35. *Id.* at 7; N. Paul Kenworthy, 11 CCH TC MEM. DEC. 60, 67 (1952).

36. "Petitioners offered a substantial amount of evidence tending to prove that the partnership earnings were derived from personal solicitation and contacts and not because of the existence of good will. They also established that good will had not been recognized as an asset at any time where a partner had died, or where a new partner had been admitted into the firm, and that no account therefor was carried on the books of the partnership." N. Paul Kenworthy, 11 CCH TC MEM. DEC. 60, 66 (1952). See also Ethel Sperling, 20 T.C. No. 141 p. 7 (1953); Arthur P. Williams, 24 B.T.A. 1070 (1931).

37. See INT. REV. CODE §§ 22(a), 117.

38. TAX COURT RULES OF PRACTICE, Rule 32.

39. The possibility of dual treatment exists apart from the administrative difficulties which attend tax enforcement. It is quite possible for the negotiating parties to have different views as to what took place. See, *e.g.*, Ralph Spitcaufsky, CCH TC MEM. DEC. ¶ 20,116 (1954), where the court found that the whole amount paid for inventory represented its value despite the taxpayer's belief that part of such cost constituted a business expense. See text at note 70 *infra*.

This divergence occurred in litigation involving the cash purchase of the stock of a corporation immediately after it had disposed of all of its assets, other than a claim against the purchaser based on a previous contract. After the stock sale, the purchaser liquidated the corporation. In the first of two proceedings, the Commissioner assessed a deficiency against the seller-stockholders, contending that the corporation settled the contract claim with the purchaser before the stock was sold, and that under the *Court Holding Company* doctrine [40] the corporation had received income taxable to the stockholders as transferees. The Tax Court denied transferee liability, since it found no pre-sale negotiations between the corporation and the purchaser.[41] In the second proceeding, involving the purchaser's right to deduct the payment as a business expense the Commissioner cited the earlier holding in favor of the stockholders as conclusive support for his position that the payment was for purchase of the stock. The Tax Court disagreed, finding from the evidence that the expenditure was clearly made to discharge the contract.[42] The court saw the true nature of the event and would not be bound by the determination in the prior proceeding that the corporation had not realized income.[43]

Acquisitions to Confer a Benefit on the Seller or the Buyer

Benefiting the Seller

The buyer may confer tax benefits on the seller by overpaying for an asset. For example, if the seller is an employee or stockholder the overpayment can be a disguised salary or dividend, but it may escape taxation as ordinary income if the transaction has the appearance of a profitable sale of property.[44] However, a close relationship between the parties and an artificial selling price will stimulate scrutiny of the transfer. And the absence of arms-length dealing makes it much easier for a court to strike down the screen surrounding the sale.[45] The overpayment can be treated as a taxable gift, compensation for services, or a dividend, depending upon the circumstances.[46]

40. Commissioner v. Court Holding Co., 324 U.S. 331 (1945). See Note, 63 Harv. L. Rev. 484 (1950).

41. Armored Tank Corp., 11 T.C. 644 (1948), *acq.*, 1949-1 Cum. Bull. 1.

42. Pressed Steel Car Co., 20 T.C. No. 24 (1953).

43. *Id.* at p. 3.

44. The extent to which the overpayment may be recouped by the buyer's subsequent sale of the property at a loss or through depreciation of the property depends on the buyer's tax bracket.

45. The question whether a personal motive has been served by an inflated purchase price arises most often when the buyer's basis for measuring the loss on disposition of the acquired property is challenged. The Commissioner has been successful in several instances in limiting the basis to the fair market value of the property at the time the buyer acquired it. Majestic Securities Corp. v. Commissioner, 120 F.2d 12 (8th Cir. 1941); New Hampshire Fire Ins. Co., 2 T.C. 708 (1943), *aff'd*, Commissioner v. New Hampshire Fire Ins. Co., 146 F.2d 697 (1st Cir. 1945); Donald McDonald, Jr., 28 B.T.A. 64 (1933).

46. See, *e.g.*, Irving R. Lewis. 19 T.C. 887 (1953) (amount owing to seller for accrued salary included in the price for his stock); Joseph Roscoe, 12 CCH TC Mem. Dec. 575 (1953) (selling commission included in consideration for stock).

Benefiting the Buyer

The manner and extent of conferring a benefit on a buyer will vary with his relationship to the seller. If the buyer is a blood relative, an employee or a stockholder of the seller, the benefit may take the form of a price concession. In these situations a bargain purchase to benefit the buyer is more successful than is overpayment to benefit the seller. The employment of the latter method is circumscribed: the seller-beneficiary must possess valuable salable property, and the close relationship of the parties breeds careful examination of the circumstances giving rise to the gain. On the other hand, a buyer-beneficiary needs only cash to make the purchase; he might even defer the payment of a part or all of the price. And a close relationship between the parties may not upset their plan to benefit the buyer. For example, an employee or stockholder who purchases stock at 20 percent of fair market value may not have to report this benefit as a salary or dividend if his right to resell the stock is restricted for a period of time.[47]

If the parties are strangers, however, the buyer seldom procures property below market price. But he may be able to do so, if the seller is in a high tax bracket and in the need of immediate cash. For example, a seller in the 90 percent bracket may desire to sell inventory held at a cost of $1,000,000. Although this cost could be realized over several years, since the inventory is worth at least that amount, the seller is willing to accept $200,000 for an immediate cash sale of the entire inventory. If he sells the entire inventory for $200,000, he will realize an ordinary loss of $800,000. But this loss can offset $800,000 of other income on which the tax would have been $720,000.[48] Thus, in exchange for his inventory, the seller in effect obtains $920,000 in cash in the year of sale. An arms-length transaction occurs, but in order to obtain immediate cash, the seller agrees to a price which is less than fair market value.

In the normal case, the price represents fair market value, and the purchaser must be content with a helpful allocation of the total amount paid. Often, this can be arranged with no prejudice to the seller. For example, a business has a net worth substantially in excess of its book figures because of appreciation in the value of machinery and the existence of goodwill. The prospective purchaser of the business wants the contract to ascribe the entire amount in excess of book value to the machinery. He will then be able to deduct a greater depreciation allowance. No similar deduction could be taken

47. Harold H. Kuchman, 18 T.C. 154 (1952), *acq.*, 1952-2 CUM. BULL. 2; Robert Lehman, 17 T.C. 652 (1951), *acq. on this point*, 1952-1 CUM. BULL. 3. In the absence of such restrictions on alienability, the discount will be taxed as a dividend to a stockholder, Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942), or as compensation to an employee, Commissioner v. Smith, 324 U.S. 177 (1945).

48. The Government has thus become an "involuntary lender" of $720,000. It may recoup its tax loss when the purchaser resells at a large profit because of his low basis. But the purchaser can postpone this tax indefinitely by adopting a last-in, first-out inventory method.

49. U.S. Treas. Reg. 118, § 39.23(l)-3 (1953).

for any value attributed to goodwill.[49] The seller, on the other hand, realizes capital gain whether his profit results from the transfer of machinery or goodwill, and thus can accede to the buyer's request without jeopardizing his own tax position.

The buyer may attempt a similar allocation when he liquidates a corporation, the stock of which he has purchased in lieu of the desired assets. The excess of his payment for the stock over the book value of the assets will be allocated chiefly to inventory and depreciable property, less to capital-gain producing assets, and as little as possible to non-depreciable intangibles. The seller is not affected by this allocation on liquidation, since he will obtain capital gain treatment on the sale of a single unit of property, his corporate stock.

Sometimes the seller accepts terms benefiting the buyer's tax position, and detrimental to his own, in order to make a deal. For example, in the sale of a controlling stock interest in a corporation, part of the price may take the form of consideration either for a covenant by the seller not to compete, or for seller's promise to perform consultative services or highly limited executive duties. The advantage to the buyer is obvious: he may amortize the cost of the non-compete covenant over its life, or he can deduct the compensation for services.[50] The solace to the seller for the loss of capital gain on such receipts consists of a better price, and the spreading of payments over a fairly lengthy period of anticipated lower income years.

To defeat such contract allocations the Commissioner must show how clearly artificial they are. This task is complicated by the fact that wide variations in the valuation of assets are commonplace.[51] Furthermore, explicit contract provisions are difficult to disregard; consultative services, continued minimum executive activity, or protection against competition—although not necessarily essential to the successful operations of a transferred business—may be very helpful.

Recent decisions frustrate any attempt to predict tax consequences in this field. In related but unconsolidated cases, the Tax Court was required to deal with the respective tax liabilities of the parties to a contract for the sale of stock, containing a covenant not to compete. The original draft of the agreement included the covenant, but no part of the contract price, $200 per share, was attributed to it. At the suggestion of the tax-conscious buyer, who advised the sellers that they would not be adversely effected, a clause was added, stipulating that the non-compete covenant was valued at $50 per share, and the stock at $150 per share. The Tax Court held that the amount allotted to the covenant was ordinary income to the seller[52] and deductible by the pur-

50. *But cf.* Mid-State Products Co., 21 T.C. No. 78 (1954), where the court disallowed the corporate taxpayer's deduction of a sum paid to a stockholder in the form of a litigation settlement because it concluded that the payment was additional consideration for the sale of his stock to the corporation's other stockholder.

51. See, for example, the Commissioner's admission that the appraiser of stock of a closely held corporation will find wide differences of opinion as to its fair market value. Rev. Ruling 54-77, 1954 INT. REV. BULL. No. 9 at 17 (1954).

52. Clarence Clark Hamlin Trust, 19 T.C. 718 (1953).

chaser over the term of the covenant as amortization.[53] The Tenth Circuit affirmed this result,[54] despite proof that there was no intention to compete;[55] despite the questionable right of one of the sellers, a trust, to engage in that type of business;[56] and in the face of a finding of fact that $150 was far below the value of each share, and $50 entirely too much for the promise not to compete.[57] The rationalization of the result better befits equity jurisprudence than tax law: the parties treated the covenant as a separate item, and, notwithstanding the seller's lack of understanding, they were put on notice and bound by the amount fixed as the covenant's value.[58]

This respect for the parties' written expression of their "understanding," and the pseudo-estoppel approach to the problem, were blithely cast aside in *Guilio Particelli.*[59] An agreement for the purchase of a winery and an inventory of wine allocated $273,000 for the winery, and $77,000 for the wine. Both parties treated the transaction in this manner on their books and tax returns. The Tax Court, cavalierly disregarding the written contract as not representing the substance of the transaction, allocated $275,000 for the wine, and $75,000 for the winery, a complete reversal of the contract allocation.

Contract allocations are not binding on the Commissioner. A totally unrealistic apportionment stands very little chance of being upheld, especially if the safeguards of bargaining give-and-take were absent. Nonetheless, the idea of inflating the value of certain kinds of assets is appealing. The only risk is the six percent interest on a subsequently assessed deficiency. Moreover, the provisions of the contract, the vagaries of tax enforcement and the possibilities of compromise make the buyer's gamble worthwhile.

Acquisitions to Obtain an Asset Different from that which is Sold

Possession of a unique product, or one for which demand exceeds supply, gives the seller a decided upper hand in bargaining. This advantage can be utilized to force a buyer to purchase a quantity of less desirable merchandise in order to get the item which he really wants. Here again, a seller with a tax awareness may see an opportunity to realize the fruits of his competitive advantage as capital gain rather than as ordinary income.

One of the most ingenious attempts to accomplish this end was the scheme adopted by American Distilling Company during World War II. This company held considerable quantities of whiskey, a commodity in tight supply

53. Gazette Telegraph Co., 19 T.C. 692 (1953).

54. Commissioner v. Gazette Telegraph Co., 209 F.2d 926 (10th Cir. 1954); Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954).

55. Commissioner v. Gazette Telegraph Co., 209 F.2d 926, 927 (10th Cir. 1954); Hamlin's Trust v. Commissioner, 209 F.2d 761, 763 (10th Cir. 1954).

56. Clarence Clark Hamlin Trust, 19 T.C. 718, 725 (1953).

57. Commissioner v. Gazette Telegraph Co., 209 F.2d 926, 927 (10th Cir. 1954); Hamlin's Trust v. Commissioner, 209 F.2d 761, 765 (10th Cir. 1954).

58. Hamlin's Trust v. Commissioner, 209 F.2d 761, 765 (10th Cir. 1954).

59. Guilio Particelli, 11 CCH TC Mem. Dec. 150 (1952). This decision was not mentioned in the cases cited notes 52 and 53 *supra.*

because of Government restrictions on production. It announced that common stockholders as of a later record date would have the privilege of purchasing substantially all of its whiskey inventory at a price equal to the company's cost. Since this cost was far below the price which liquor dealers would have paid for whiskey, the effect of the announcement was to create a great demand for, and thus increase the price of, American Distilling's common stock. This plan spawned a group of cases involving taxpayers who bought shares of stock solely to obtain supplies of whiskey, and sold the stock at a loss after the inventory distribution. In each decision the stock and whiskey acquisitions were joined together. This led to holdings that the shares were not capital assets, and that the loss incurred on the resale of the stock was properly deducted from business income.[60]

The opinions in the whiskey cases raise some problems concerning the proper characterization of investment-type property.[61] It is unrealistic to remove stock from a capital asset classification by depicting it as property held primarily for sale to customers in the ordinary course of a liquor dealer's business. Merging the loss suffered on the disposition of the stock with the cost of the whiskey may be satisfactory where, as in these cases, the stock loss antedates or occurs in the same year as the resale of the whiskey. But if the shares are disposed of in a later year than the desired asset, would the courts be more inclined to treat the shares as capital assets, and the loss as a capital loss?

This question faced the Tax Court in *McGhee Upholstery Co.*[62] The petitioner, in 1946, in order to get springs needed for its furniture manufacturing business, had to purchase some of the seller's stock for $5,000. A year later it sold this stock back to the president of the spring company for $750, and deducted the $4,250 loss from 1947 operations by charging it to cost of goods sold in that year. The court's decision that the loss could not reduce 1947 business income was based on two grounds. First, the record was too meagre to support a conclusion that the transaction was other than the purchase and sale of a capital asset.[63] This is naiveté, at best. As a second ground, the taxpayer's attempt to treat the loss as a cost of 1947 goods purchased, or an an operating loss in that year, was considered clearly erroneous.[64] The court did not indicate, however, the year in which the stock transaction should have been reflected.

60. Charles A. Clark, 19 T.C. 48 (1952); Western Wine & Liquor Co., 18 T.C. 1090 (1952), *appeal dismissed*, 205 F.2d 420 (8th Cir. 1953); Hogg v. Allen, 105 F. Supp. 12 (M.D. Ga. 1952). *Cf.* Tube Bar, Inc., 15 T.C. 922 (1950), where a purchaser's loss on resale of the real estate and chattels of a retail liquor business was held to be a capital expenditure by the purchaser to acquire the accompanying liquor license.

61. *See* Western Wine & Liquor Co., 18 T.C. 1090, 1099 (1952) (dissenting opinion). Four judges joined in this dissent on the ground that the majority view would engender confusion in the tax treatment of investment-type property.

62. 12 CCH TC MEM. DEC. 1455 (1953).

63. *Id.* at 1456.

64. *Ibid.*

The overpayment for the stock should have been charged against income from sales of furniture that contained the acquired springs. In all of these situations, it is more correct to say that the amount exceeding the value of the unwanted asset represents additional payment for the desired article than that a loss subsequently incurred on disposition of the unwanted asset constitutes an addition to the wanted article's cost. By treating this excess over fair market value as part of the cost of the inventory item, it enters into the computation of income at the same time as the inventory itself. Furthermore, distortion will be avoided, since the investment will maintain its character as a capital asset with a basis determined by its fair market value at the time of acquisition.

The absence of a clear outline of the application of the substance-over-form concept makes it difficult to evaluate and integrate pertinent precedents. The *McGhee Upholstery* case shows that it is not easy to pinpoint the foundation for a decision which upholds artificial inter-party arrangements. A court may be rejecting the applicability of the principle itself; or it may only be holding that there is insufficient proof of the substance behind the arrangements.[65] The result may also stem from the taxpayer's improper handling of the tax consequences of the transaction or from his erroneous choice of the taxable period in which to account for the event.[66]

Exposition Souvenir Corp. v. Commissioner[67] illustrates the confusion engendered by a failure to articulate the role of substance-over-form. The taxpayer, a concessionaire, purchased debentures of the non-profit corporation conducting the 1939 New York World's Fair, in order to acquire a concession. The Tax Court found that the concession would not have been awarded nor renewed for the following year if the taxpayer had not purchased and held the bonds. Nonetheless, the Second Circuit held that the loss resulting from disposition of the debentures after they had served their purpose was a capital loss. The court adhered strictly to form in rejecting the taxpayer's first two contentions: either (1) the bonds were property held for sale to customers in the ordinary course of business, or (2) the loss was an ordinary and necessary business expense.[68] But the court hinted that the substance of the trans-

65. For example, the taxpayer may fail to show the excess of purchase price over market value of the unwanted asset. See text at note 69 *infra*.

66. A deduction of the entire payment made for the capital asset, or vacillation in the basis for the deduction undermines the taxpayer's argument that part of the purchase price for the asset was a disguised ordinary income payment. See, *e.g.*, Millinery Center Corp., 21 T.C. No. 92 (1954); Burt L. Davis, 26 B.T.A. 218 (1932).

67. 4 CCH TC MEM. DEC. 687 (1945). *aff'd*, 163 F.2d 283 (2d Cir. 1947).

68. Exposition Souvenir Corp. v. Commissioner, 163 F.2d 283, 285, 286 (2d Cir. 1947). The court seems to close its eyes to substance when it concludes that the transaction was an investment in form and substance, "a risky one to be sure and motivated not by a desire to make capital gains or to earn 4% interest but by the desire to acquire the concessions, . . . none the less an investment since money was expended for property, i.e., the debentures." *Id.* at 286. It must be noted that the taxpayer laid the groundwork for this definition of the debentures by treating them as investments on his books and previous tax returns.

action might have been recognized under a third argument that the loss was really a bonus paid to obtain the concession. However, the taxpayer could not show that a definite amount had been paid to obtain the concession, since it measured the bonus by the loss on the resale of the debentures rather than by the initial overpayment. The taxpayer's computation of the bonus was thus dependent in part on market fluctuations. This mistake in the taxpayer's treatment of the deduction was highlighted by the court's statement that it was not "possible to divide the $130,000 [the entire payment by the taxpayer], and say that part was paid for the debentures and part as a bonus for the concession contracts, since there was no evidence as to the market value of the debentures at the date of their purchase."[69] Presentation of proof on this question might have produced a different result.

CONCLUSION

The principle of substance-over-form is not applied as consistently as it is acknowledged. The Tax Court will allow a deduction if an asset is nominally purchased but the entire payment is really an expense item, or if there is an actual asset acquisition but a separate amount is allocated to an expense item. However, as in *Burt L. Davis*, the deduction is lost if the purchaser through ignorance or necessity fails to separate the expense item from the amount paid for the asset.

Sometimes the parties may have genuinely different conceptions of the transaction. For example, the seller may feel that his asset is worth $1,000,000, but the purchaser believes everything in excess of $500,000 constitutes a business expenditure not related to the acquisition of the asset. Here, substance dictates different tax treatment for the seller and the buyer, a result not unique in taxation.[70] The safeguards against abuse of this divergent result lie in the difficulty of proof.

But a taxpayer should have the right, as the courts often have held, to prove that the terms of an agreement do not represent the true nature of the transaction. If the buyer demonstrates that part of the ostensible price of an asset was paid in furtherance of an ordinary income transaction, it is inequitable to deny a deduction of this amount merely because the seller or circumstances forced him to accede to a disguise. Nor should the seller obtain favored capital gain treatment by his artifice. Conversely, the seller should not be burdened, nor the buyer benefited, when the seller is forced to accept as ordinary income what is in fact part of the purchase price. Although judicial unwillingness to unravel artfully disguised transactions may explain the failure to apply the principle of substance over form, complexity and difficulty do not justify departure from this well recognized principle.

69. *Ibid.*

70. See, *e.g.*, Commissioner v. Ashland Oil & Refining Co., 99 F.2d 588 (6th Cir. 1938); Pressed Steel Car Co., 20 T.C. No. 24 (1953).